MICHAEL J. MURPHY
State Treasurer

First Quarter 2005

The QUARTERLY

Local Government Investment Pool

Is the Fed ahead of the inflation curve?

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At its March 22 meeting, the Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate by 25 basis points (bp) to 2.75 percent, as widely expected by investors. The Fed maintained both the “measured” and “accommodative” language in its policy statement but highlighted a greater concern about growing inflation risks. The Fed added “... pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices.”

The Fed’s latest policy statement provides enough warning that it will act aggressively if the inflation picture deteriorates significantly during the course of this year. Investors should be cognizant of the fact that the Fed’s main goal is to establish price stability without extinguishing economic growth. Inflation pressure seems to worry the Fed a lot as both cost and output pressures are evident.

In fact, the Fed’s slightly stronger tone of “output evidently continues to grow at a solid pace” as opposed to its February statement that said “output appears to be growing at a moderate pace” provides a visual on how the economy is growing at a solid pace. Investors are reminded that the economy is working on its strengths to deliver a much more convincing growth story.

Inflation

The most significant event that transpired during the last FOMC meeting was the change in the perception of inflation risk. The Fed implied that inflation concerns have gotten to an elevated level. The subtle language change indicates a more substantial tightening cycle than previously thought by interest rate watchers. Energy prices have prompted economists to worry about the latent effect of producers passing the costs of energy prices to consumers.

Oil prices reaching new records every day have investors worried about the “cost-push effect” on production and consumption. Oil prices have gone much higher on a steeper trajectory as world demand has gone well above analysts’ estimates. Who would have thought that prices could go up to $58.28 a barrel? Yet, some analysts are now projecting oil prices to reach $100 a barrel.

The OPEC cartel has clearly stated a commitment to increase supply but the problem is most of the cartel members are producing oil at full capacity. Increasing oil supply will be at best marginal even if OPEC increases its ceiling to 800,000 barrels of oil by the fourth quarter of CY 2005. A contrarian view is for energy prices to peak and eventually correct to around $45-50 a barrel, due to weaker demand and higher inventories for spring.

Production costs have taken a toll on consumer prices since many raw materials have shown major price hikes as reflected by the CRB index. Higher fuel costs have boosted companies’ production costs. Major manufacturing firms have complained about rising raw materials and their intention of

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Market summary

from page 1

passing on added costs to consumers to protect their profit margins.

Another catalyst that could trigger more worries is the tightening labor market. Private-sector wages have grown at a nearly 6 percent pace in ’04, and the services sector which is a component of the expanded labor income has shown an 8.65 percent rise over the same period. Although the non-farm payroll was weak in March, anecdotal evidence of a growing labor market belies the payroll weakness.

The strong economic numbers and weak job numbers for March send a conflicting message about the economic landscape, but an overall view of economic prospects remains strong. March reports suggest the slowdown in payroll could be simply due to the volatility in payroll numbers.

U.S. economy’s report card

The U.S. economy has shown considerable signs of resiliency compared to the rest of the world. It has been the engine of growth of global economic expansion despite increasing worries about the country’s economic fundamentals. Higher interest rates, weakening value of the dollar, lopsided trade and current account deficits have not deterred the U.S. economy from improving output.

In the last quarter of 2004, the economy grew at 3.8 percent, lower than the 4 percent median economists expected. The GDP price deflator for the same period rose 2.3 percent, higher than the 2.1 percent estimate. The deflator has stayed between 1 and 3.6 percent over the past five years which shows inflation is still manageable.

There are signs, however, that growth could slow if a continued rise in commodity prices is left unabated. The GDP forecast could be severely affected by the latent impact of higher oil prices. Economists worry that if energy prices translate to inflation immediately or if higher prices severely depress disposable income and consumer sentiment, it could slow economic growth in the latter half of the year.

Policymakers are watching to see how they can balance their twin objectives of fostering maximum sustainable growth and price stability despite current challenges. Philadelphia Federal Reserve Bank President Santomero has said monetary policymakers need to be “flexible” in the speed they change interest rates because it cannot afford the risk of policy getting “behind the curve.” Simply put, the Fed will do whatever it takes to contain inflation to achieve a sustainable economic growth.

The difficulty behind this balancing act is that most data have long and variable lags that could create temporary dislocation, which is why the Fed needs the flexibility when it comes to raising interest rates. Removing monetary accommodation at a “measured pace” depends on inflation-growth dynamics.

Investors are currently preoccupied with the thought that the Fed could indeed raise rates by more than 25 bp in any one of the succeeding meetings this year if longer-term inflation expectations pose risk to monetary stability. Year-end fed funds rates are estimated to be around 4-4.5 percent.

The bond market

Greenspan said the long bond rates were a “conundrum” when asked why the yield curve was so flat. Bond yields should move higher in a tightening environment unless investors are expecting a different growth scenario. Investors could be buying longer papers if they are expecting that the Fed will stop raising rates by the end of the year with less inflation and growth prospects in 2006. People do remember some Fed comments about neutrality in Fed rates at around 4-5 percent.

The lower than expected March non-farm

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360-902-9022

Noah Crocker
Real estate specialist
360-902-9020

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LOCAL specialist
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Market summary
continued

payroll spurred a short-covering rally, leading investors to reinstate their bear flattening trades. Several Fed members came out to say that one non-farm number does not change their view on inflation, which made investors glad to hold on to their flattening trades. Yet, with all the gyrations in the bond market, the yield curve has stayed flat.

The 10-year bonds traded in a range between 4.12-4.30 percent, the same range it held since the start of the year. The 2-year also performed within its range of 3.4 to 3.75 percent, but briefly tested the 3.9 percent level during the same period. It should be noted that the yield curve experienced a period of brief steepening that was completely reversed when the March economic numbers were released.

In general, the April economic numbers proved disappointing, raising speculation about the economy losing momentum. This concern created a very strong short covering, bringing the bond prices almost to their highest trading band. There is a growing sentiment that weaker economic numbers and consumer confidence have reduced speculation of a 50 bp hike either in May or June.

If inflation is well-contained and within tolerable limits, the Fed would not need to raise rates aggressively. The current shape of the yield curve could be pricing in moderating expectations on economic growth, but this could also be a temporary dislocation. Economists have started revising down their growth forecast for the year because of concern about higher energy costs and feeble economic recovery in Europe and Japan.

In the quest for higher yields, agency notes became attractive as most rates within the 18-month period were better than their breakeven rates, assuming a 25 bp rate hike every meeting. These rates provided investors more cushion to interest rate moves than what the treasury or discount notes were offering. The only downside was the narrow spreads the agency market had versus treasuries. This fact was largely ignored by real money players as most attributed the narrow spreads to fewer headline risks in the future.

LGIP yields continue to climb

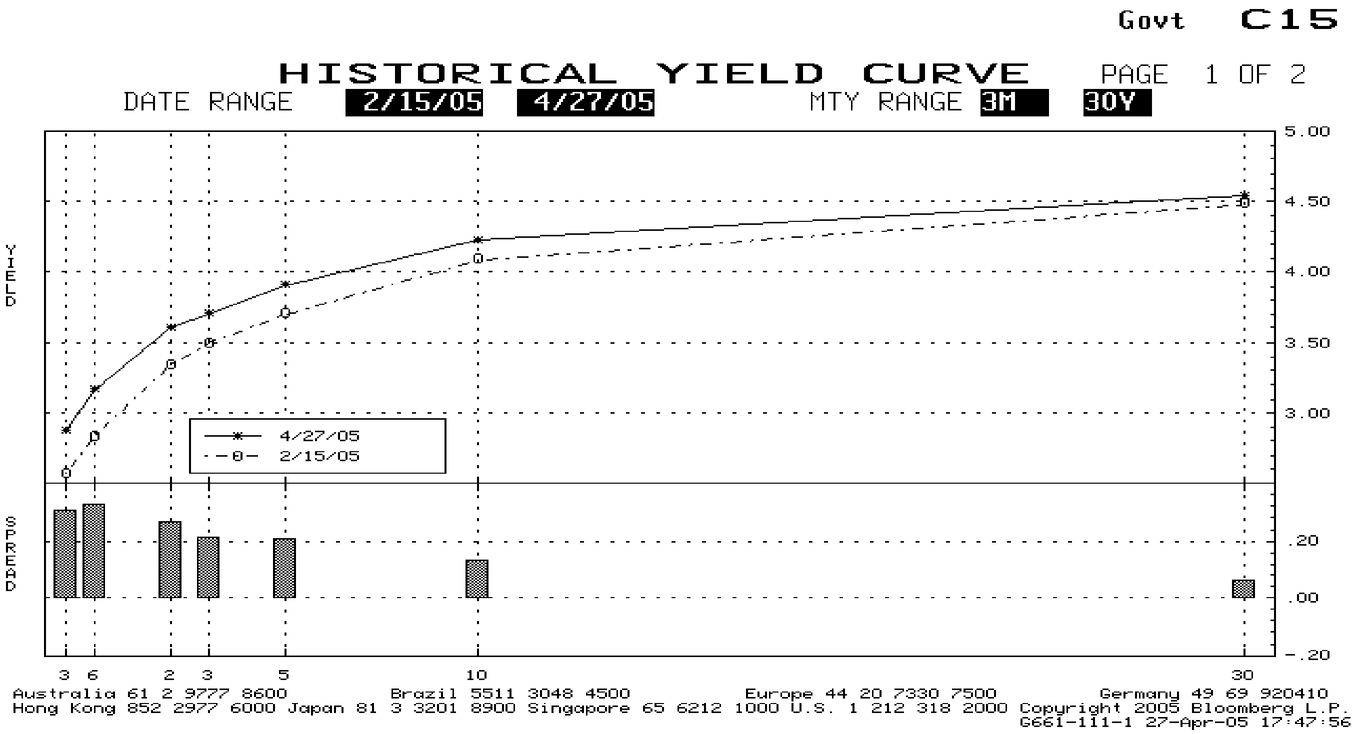
The fed funds rate was raised by 25 bp at both the Feb. 2 and Mar. 22 FOMC meetings, bringing the rate to 2.75 percent. The Fed is widely expected to raise the rate again by 25 bp at the May 3 FOMC meeting. In anticipation of rising rates, the average life of the LGIP portfolio has been kept around 30 days, in order to be able to reprice to the rising funds rate as quickly as possible.

Accordingly, the net LGIP yield increased from 2.22 percent to 2.40 percent and then 2.55 percent during January, February and March, respectively. LGIP partiicipants should expect the LGIP yields to continue to rise as long as the Fed continues to raise the fed funds rate.

OST extends Bank of New York as custody and securities lending agent

Treasurer Murphy has announced a two-year extension, with no fee increases, of The Bank of New York's (BONY) appointment as the provider of custody and securities lending services for the OST investment program.

The contract, which was scheduled to terminate on Sept 30, has been extended to Sept. 30, 2007. The strong level of service provided by BONY and the performance of the securities lending program, combined with the attractive fee schedules, makes this extension a real positive for LGIP participants and state government.



From the LGIP Administrator's Desk

By Jen Thun

Requesting LGIP Transactions

Many participants have their own way of requesting transactions. In an effort to avoid any confusion or errors, I want to clarify what transfers, deposits, and withdrawals really are.

A *transfer* is a request to move funds from one of your LGIP accounts to another LGIP account. A transfer involves no actual movement of money. Transfers only apply to participants who have bond accounts in the LGIP in addition to their primary account.

When you request a *deposit* you will be wiring funds from your bank account to the LGIP for investment. Participants frequently state "we would like to invest" or "we will be sending $30,000" when they initiate a deposit.

A *withdrawal* is a request to have the LGIP wire funds from the LGIP to your local bank account. Some people may say "we would like to sell investments" or "transfer to my bank" or "we need $30,000" to request a withdrawal.

These remarks may seem fairly self-explanatory, but phrases such as "we need a transfer of $30,000" or "we need $30,000 deposited" are a lot more ambiguous and could lead to a misunderstanding. The LGIP wants to ensure we are performing transactions just as you intended. Therefore, it will be helpful to keep this terminology in mind when you request a LGIP transaction. If you have any question or concerns, feel free to contact the LGIP Administrator at 1-800-331-3284.

Alert: CDARS program not legal for investing public funds

Many public treasurers in Washington were recently sent an e-mail offering very attractive CD rates through the CDARS program. Not only was it too good to be true, CDARS investments are not legal in this state for public money.

Washington state is unique in the way it protects the deposits of all its public treasurers. When made in accordance with the Public Deposit Protection Act, RCW 39.58, all public deposits are covered in full by pooled securities. These securities are pledged by participating public depositaries – commercial banks, savings banks and savings associations. This system helps streamline the process of insuring the public's money from loss, for both the public treasurer and the financial institution.

Several banks in Washington belong to CDARS, or Certificate of Deposit Account Registry Service. This service is provided through Promontory Interfinancial Network, LLC, headquartered in Washington D.C. This program allows a customer to establish a relationship with a network member and make a deposit up to $5 million. When the network member accepts a large deposit, it places the deposit (in increments less than FDIC protection) with other banks in the network, thus making the entire $5 million protected by FDIC.

The CDARS program is not a legal investment vehicle for public deposits. Nor is it necessary for our state's public treasurers to be concerned with having their public deposits protected by FDIC.

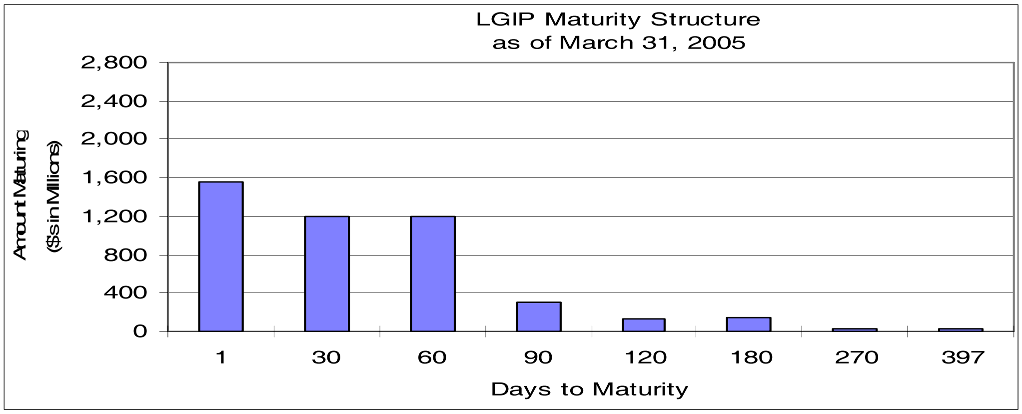
A time deposit is a single maturity or multiple maturity interest bearing investment of public funds, which is either evidenced by a certificate of deposit issued by a public depositary, or reflected in a book-entry system of such depositary approved by federal regulatory authorities, state supervisor of banking and/or state supervisor of savings and loan associations, and which is payable to a treasurer on a certain date.

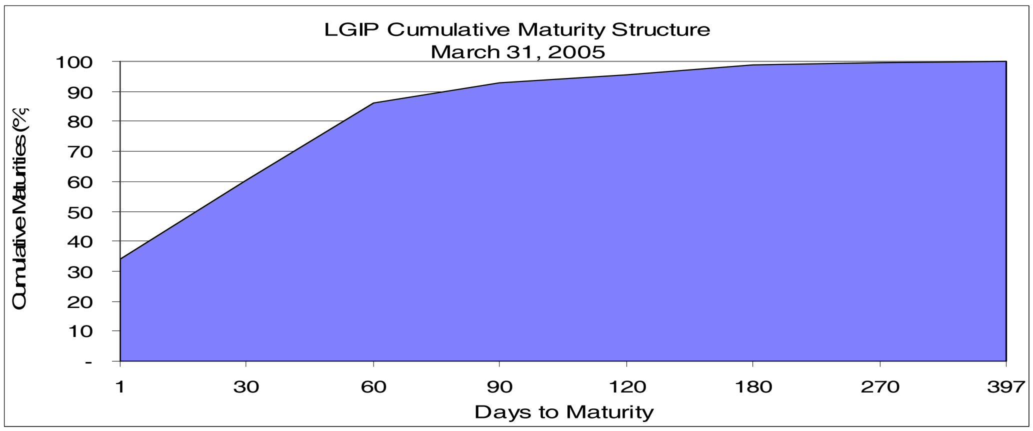
Such certificate shall not be negotiable, nor an interest in an investment deposit transferable, except between treasurers and/or public depositaries. Approved public depositaries are located, or have branches located, in Washington State and a listing is available at http://tre.wa.gov/PDC/pdpc.htm.

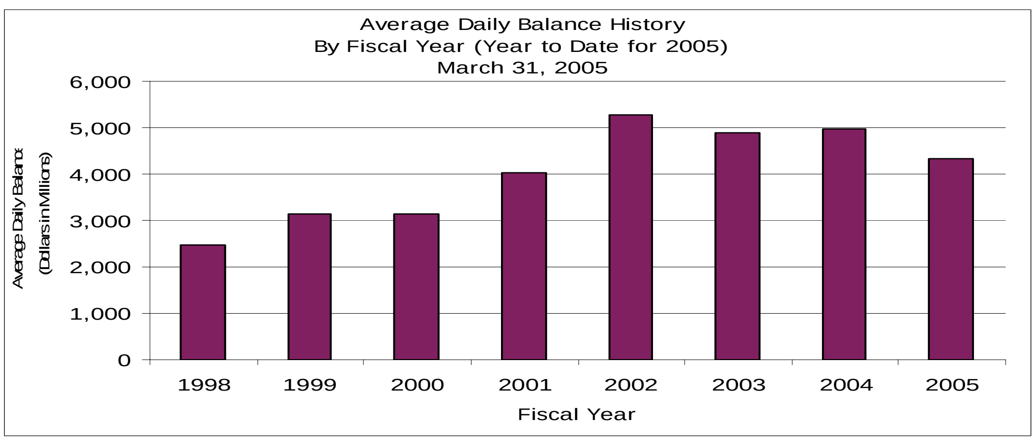
LGIP Holiday Schedule for 2005

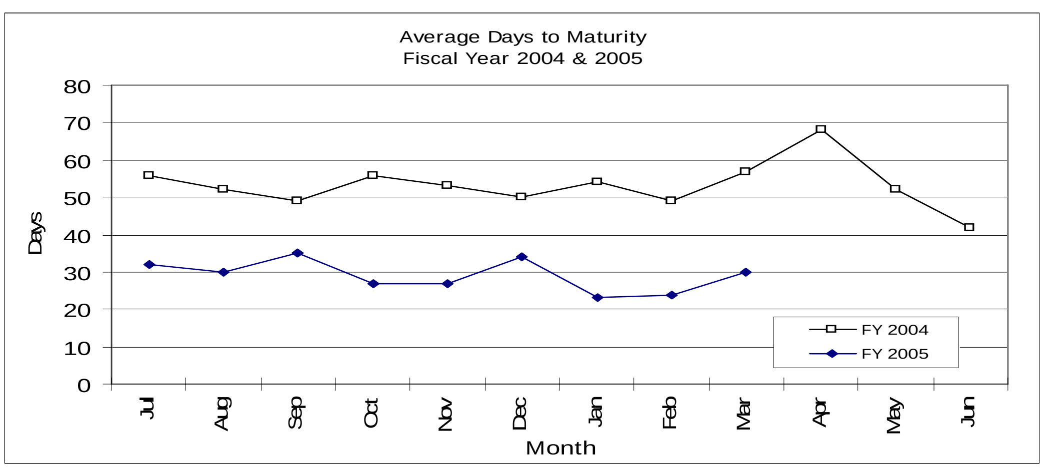
The Local Government Investment Pool will be closed on the following days:

Monday	May 30	Memorial Day
Monday	July 4	Independence Day
Monday	September 5	Labor Day
Monday	October 10	Columbus Day
Friday	November 11	Veteran's Day
Thurs/Fri	November 24-25	Thanksgiving holiday
Monday	December 26	Christmas

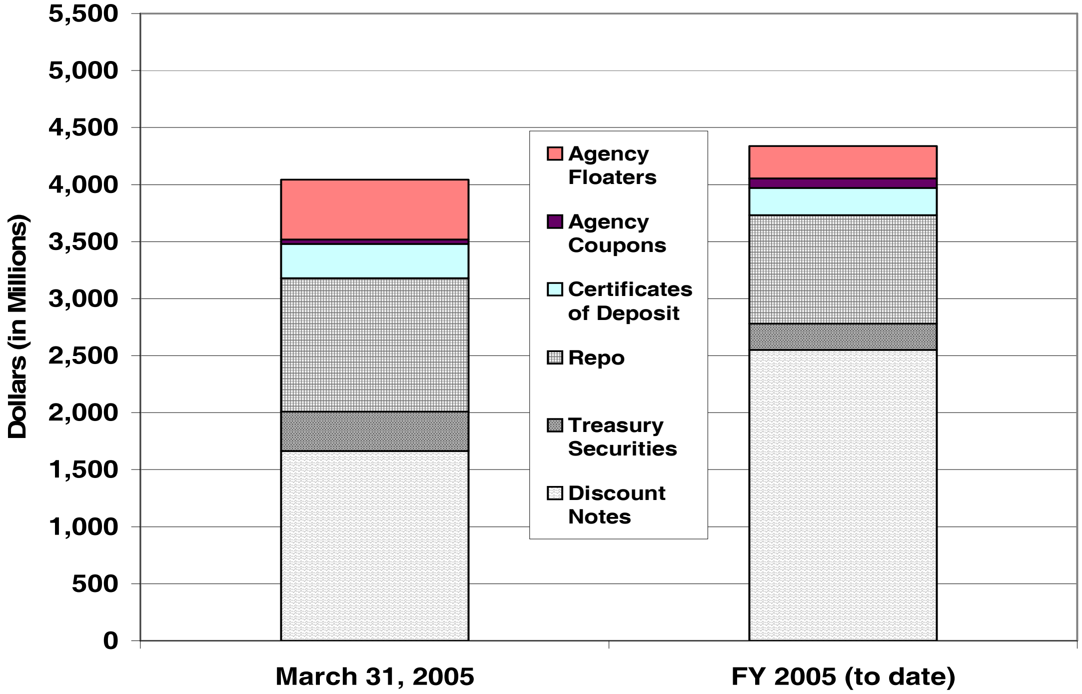

LGIP Maturity Structure
as of March 31, 2005
Amount Maturing ($s in Millions)
2,800
2,400
2,000
1,600
1,200
800
400
0
1
30
60
90
120
180
270
397
Days to Maturity

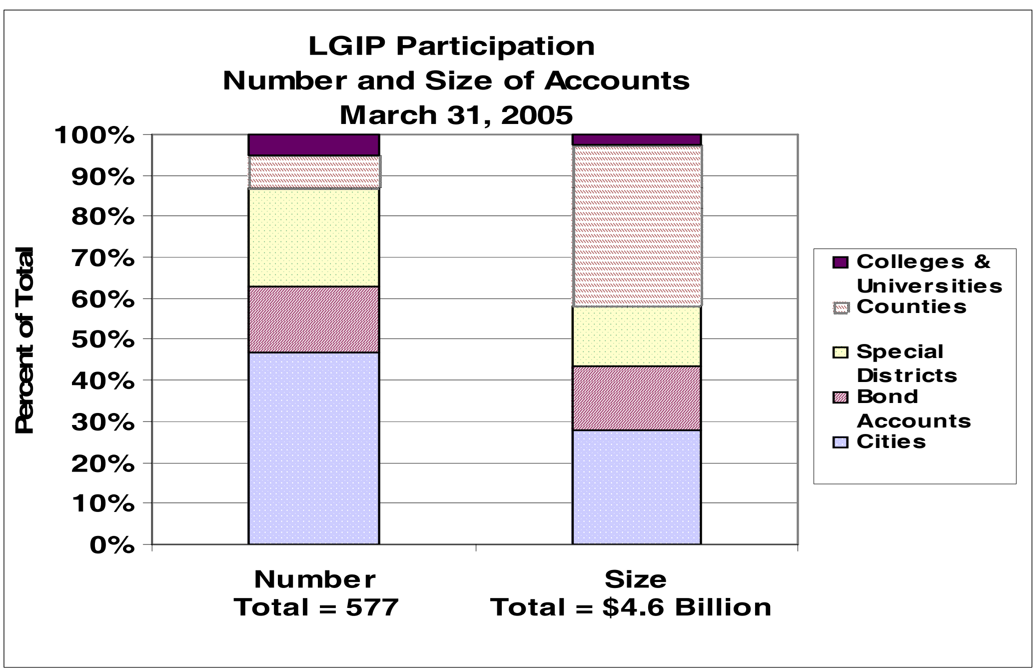

LGIP Cumulative Maturity Structure
March 31, 2005
Cumulative Maturities (%)
100
90
80
70
60
50
40
30
20
10
-
1
30
60
90
120
180
270
397
Days to Maturity


Average Daily Balance History
By Fiscal Year (Year to Date for 2005)
March 31, 2005
Average Daily Balance (Dollars in Millions)
6,000
5,000
4,000
3,000
2,000
1,000
0
1998
1999
2000
2001
2002
2003
2004
2005
Fiscal Year


Average Days to Maturity
Fiscal Year 2004 & 2005
Days
80
70
60
50
40
30
20
10
0
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
Month
FY 2004
FY 2005

Portfolio Composition
Average Balance by Security Class





LGIP Advisory Committee: Lewellen, Jacobson, Shawa, Finkelstein appointed

State Treasurer Murphy announced the appointments of Carrie Lewellen, Treasurer, City of Vancouver; and Morgan Jacobson, Treasurer, City of Tacoma. Tracy Shawa, Pacific County Treasurer, was appointed by the Washington State Association of County Treasurers, and Stan Finkelstein was reappointed by the Association of Washington Cities. These appointments are all for three-year terms which will expire on April 30, 2008.

Treasurer Murphy announced the expiring appointments of advisory committee members Stan Finkelstein, Paula Henderson, Rick Patrick and Linda Wolverton as of April 30, 2005. He presented a certificate of appreciation to Paula Henderson for serving on the advisory committee from November 2001 to April 2005. Rick Patrick served on the committee from February 1998 to April 2005, and Linda Wolverton served on the committee from November 2002 to April 2005. Rick and Linda were unable to attend the meeting to accept their certificates.

In other business at the committee's March 25 meeting, a brief update was given on the net LGIP returns for January and February. The fed funds rate increased 25 basis points (bp) at the last two FOMC meetings and it is anticipated there will be another 25 bp increase at the May 3 meeting. A handout was distributed to committee members describing a breakeven analysis regarding discount note yields. The gross rate for the LGIP was 2.57 percent in March and it is anticipated the rate will be about 2.72 percent in April. The LGIP has outperformed its benchmark, iMoneyNet, Inc., by an average of 44 bp.

The strategy for the management of the LGIP portfolio was discussed. The portfolio has an average life of 34-35 days. The strategy is to keep short in anticipation of continued fed fund increases.

A handout was distributed to committee members describing LGIP month-end balance activity and daily balance activity for FY 2004 and FY 2005. The balance currently is $4 billion.

Doug gave a brief update on the IBC/MMX Conference he attended in Orlando, Florida. He also gave a brief report on iMoneyNet. He explained that iMoneyNet reports net and gross performance, as well as other information, of private 2a-7 money funds. A group of those funds serves as a valid performance benchmark for the LGIP. OST is paying $6,600 a year for three publications through iMoneyNet. In early March, iMoneyNet informed OST that in order for OST to reference their information on the website or in the LGIP newsletter, they would have to charge us a $5,000 fee. Upon further discussion between both parties, the issue has been resolved and no fee will be charged.

Treasurer Murphy gave a brief overview regarding proposed legislation that would grant carte blanche investment authority to certain public hospital districts. OST is strongly opposed to this and Treasurer Murphy sent a letter dated March 22 to all Senators, a copy of which was given to committee members, in opposition of Substitute House Bill 1341 and House Joint Resolution 4202. The legislation passed the House 95 to 1 and is now in the Senate.

A change was proposed to the LGIP Investment Policy regarding Appendix 1, which lists authorized persons who can conduct trades. It was proposed that Appendix 1 be deleted and revisions to the policy language stating that OST would maintain a current list of those authorized persons, which would be available upon request. A motion was made by Stan Finkelstein and seconded by Dani Burton to approve this amendment to the LGIP Investment Policy and the vote was unanimous to accept the revisions.

It was reported that 70 percent of all transactions during the last quarter were made through TM$. Jen is cross-training other Investment Section staff to fill in when she is out of the office.

A brief update was given on the custody and securities lending contract extensions with The Bank of New York. The extensions have been agreed upon and OST is now going through the process of executing the documents.

The FY 2005 budget was reviewed utilizing a handout showing the budget estimates for FY 2005. The estimate of fees and overdraft charges of $1,503,365 is slightly higher than the original estimate of $1,404,000, and the expenses of $571,523 are lower than the original estimate of $579,000. The estimated rebate for FY 2005 is now $931,842, which exceeds the original estimate of $825,000 by $106,842.

(Subsequent to the Advisory Committee meeting, Treasurer Murphy testified in front of the Senate Government and Operations Committee in opposition to HB 1341 and HJR 4202. The bills failed to make it out of committee.)

Washington State Local Government Investment Pool
Position and Compliance Report
as of 3/31/2005

(Settlement Date Basis)

(in Thousands)

LGIP Portfolio Holdings

		Cost	Percentage of Portfolio
U.S. Agencies	$	25,409	0.55
U.S. Callables		25,000	0.55
U.S. Agency Generic FRN		539,931	11.79
Certificate of Deposit		121,250	2.65
Discount Notes		1,777,819	38.82
Interest Bearing Bank Deposits		226,759	4.95
Repurchase Agreements		1,574,065	34.37
U.S. Treasury Bills		163,891	3.58
U.S. Treasury Coupons		125,080	2.73
***Total Excluding Securities Lending**		4,579,204	100.00

Securities Lending Holdings

Repurchase Agreements	308,435
Total Securities Lending	308,435

Total Investments & Certificates of Deposit $ 4,887,639

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

	Portfolio Holdings	Portfolio Percentage	Policy Percentage
Floating Rate and Variable Rate Notes	539,931	11.79	30%
Variable Rate Notes > 397 days	50,000	1.09	10%
Other Structured Notes	25,000	0.55	10%
Term Repo > 30 days	-	0.00	30%
Certificate of Deposit	121,250	2.65	10%
Bankers' Acceptances	-	0.00	20%
Commercial Paper	-	0.00	25%
Reverse Repo	-	0.00	30%
Security Lending + Reverse Repo	303,788	6.63	30%

Maturity Limitations (Days)	Currently	Policy
Weighted Average Maturity	30	90
Maximum Maturity		
Bullet Maturities	321	397
Floating Rate and Variable Rate Notes	417	762
Repos	7	180
Reverse Repos	0	90

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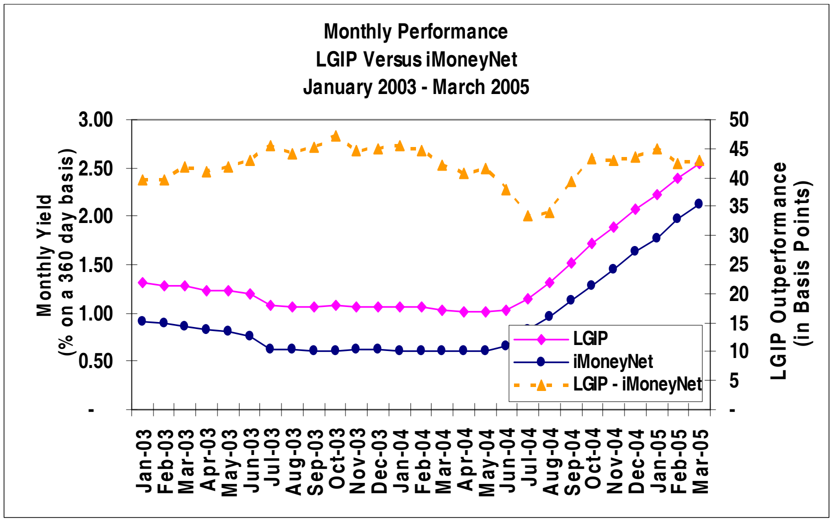
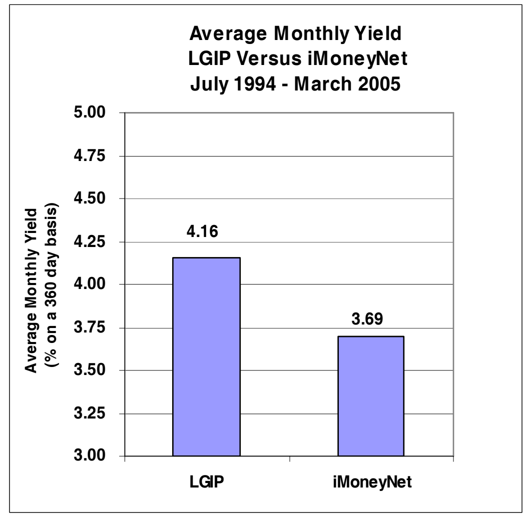
Repo Limits Per Dealer

	March 31, 2005	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 04/01/2005	Projected Position 04/01/2005
Banc America Securities	515,000	11.25%	0.00%	515,000	-
Bear Stearns & Co.	200,000	4.37%	4.37%	-	200,000
Goldman Sachs	158,424	3.46%	0.00%	158,424	-
Lehman Brothers Inc.	659,065	14.39%	2.18%	559,065	100,000
Merrill Lynch	200,000	4.37%	4.37%	-	200,000
Morgan Stanley Dean Witt	150,012	3.28%	0.00%	150,012	-
Total	1,882,501			1,382,501	500,000

LGIP Performance Comparison

iMoneyNet, Inc. [1]
versus
Local Government Investment Pool





The chart on the left shows a monthly comparison from January 2003 through March 2005 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to March 2005. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.4 basis points. This translates into the LGIP earning $170.11 million over what the average comparable private money fund would have generated.

[1] Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Local Government Investment Pool

STATEMENT OF NET ASSETS
March 31, 2005
(in Thousands)

Assets		
Investments, at Amortized Cost:		
Repurchase Agreements	$	1,574,065
U.S. Agency Securities		2,368,159
U.S. Treasury Securities		288,971
Total Excluding Securities Lending		4,231,195
Securities Lending Investments, at amortized cost:		
Repurchase Agreements		308,435
Total Investments (Settlement Date Basis)		4,539,630
Due to Brokers - Securities Sold But Not Settled, at Amortized Cost:		
U.S. Treasury Securities		(49,722)
Total Investments (Trade Date Basis)		4,489,908
Interest Bearing Bank Deposits		226,759
Certificates of Deposit		121,250
Cash		1
Interest Receivable		4,470
Investment Maturities Pending Receivable		49,728
Total Other Assets		402,208
Total Assets		4,892,116
Liabilities		
Accrued Expenses		558
Obligations under Securities Lending Agreement		308,435
Total Liabilities		308,993
Net Assets	$	4,583,123
Total Amortized Cost - Settlement Date Basis	$	4,887,639

QUARTER AT A GLANCE
January 1, 2005 to March 31, 2005
(in Thousands)

Total investment purchases:	$	30,324,681
Total investment sales:	$	530,787
Total investment maturities:	$	29,564,480
Total net income:	$	24,304
Net of realized gains and losses:	$	2
Net Portfolio yield (360-day basis):		
	January	2.2197%
	February	2.3955%
	March	2.5502%
Average weighted days to maturity:		30 days

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
OFFICE OF THE STATE TREASURER
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